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Foreign Trade and Exchange Risks

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Writer Points Out That Bretton Woods Agreements Do Not Assure Stable International Exchange Rates Required to Foster Foreign Trade and Maintains That the Foreign Exchange Dealer or Speculator Will Be Required, as in the Past, to Carry Out This Function if Free Exchange Markets Are to Prevail. Opposes Government Guaranty of Exchange Rates But Holds That Central Banks, by Assuming a Monopoly of Exchange Transactions, Can Manipulate Rates. This, However, He Asserts, Would Permit a Political Rather Than an Economic Basis of Exchange Control.

Sixty million jobs, 150 billion national income, 10 billion foreign trade are some of the slogans by which—without much concern for the relation of cause and effect—the post-war economic problems are usually expressed. Advertising experts say that slogans are very effective means to attract buyers in a sales campaign or even voters in an electoral campaign, but I really doubt that they are as effective to clarify complicated economic problems. I believe that this purpose will be served better focusing our analysis one by one on the multiple questions involved in the general problem. Within the limits of this article I shall try to find some answer to the question with which the foreign trade will be faced: Who will bear the risks of exchange fluctuations?

Rudolph Berdach

I do not intend to discuss here the problem of foreign trade on a broad basis. I want only to observe that although about 90% of the production of the United States is consumed in the country, it is not necessary to be familiar with the theory of marginal utility to understand the importance, for the price structure, of a surplus of 10% of the production and to appreciate the overwhelming necessity of foreign trade for the economy of this country.

In a recent speech, Dean Acheson, Assistant Secretary of State, called for "the creation of circumstances favorable to increase trade." In these circumstances he included "a reasonable rate stability for considerable period of time; assurance that the exporters will be paid not in some blocked foreign currency, but in dollars; elimination of exchange discriminations and multiple currency systems." This is, of course, a fine program and about the same with which the monetary conference in Bretton Woods concerned itself.

Now how far was this program carried out in Bretton Woods? The monetary plan which finally was accepted—with more or less reservations to be sure—by 44 nations, granted to every member nation the right to change its exchange rates within the limits of 10% on short notice and to propose other depreciations to adjust a fundamental disequilibrium. The fund would have to agree to a proposed depreciation on the ground of "fundamental disequilibrium," but this term is undefined and the only provision is of a negative nature, i. e., the fund may not question a disequilibrium on the ground that it was caused by domestic, social and political policies. There is no provision in the fund excluding the possibility for one or the other nation to use these stipulations as a "usual" method of international trade adjustment.

It is a question of interpretation whether the rates established under these rules may be considered as "reasonably stable for a considerable period of time," but I feel quite sure that the foreign trader will not consider them as such. He will therefore have to find ways and means to eliminate these exchange risks which are suspended over his head as a permanent menace which may materialize every moment.

Even in the 25 years preceding World War I, when the exchange risks, under the general rule of the gold standard, were reduced to a minimum, the foreign trader found it advisable to cover his foreign exchange risks in the, then large, future exchange markets.

The function of a large future exchange market assumes the existence of certain conditions: freedom of international capital transactions and the existence of a certain amount of international speculation. A class of speculators is as indispensable for the functioning of an exchange future market as it is for a large stock or security market. It is commonplace to judge speculation as something unethical, yet it fulfills an economic task. It carries the burden of certain risks, inevitable in our capitalistic economic system of production for the market, and in so doing removes it from the traders' shoulders. It is obvious that the totality of the exporters who have to secure the exchange rate of the products they have sold against future payment cannot possibly hope to find an equal totality of importers who are desirous to secure the exchange rate of the merchandise they have bought against future payment. This would only be possible if the volume of the outstanding obligations resulting from sales and purchases in one particular exchange at one particular date were always equal. The problem can be solved only by the professional dealer or speculator who is ready to step in straightening out the difference between demand and offer.

Besides, the speculator has to fulfill the further task of being responsible for certain conditions which he exploits without having created them. A government, for instance, which by its monetary policy has disorganized its monetary system, usually makes the speculator the scapegoat. In reality the speculator is as responsible for the depreciation of a currency as a man who pours a cup of tea into a river is responsible for a flood.

Another factor in the future exchange market is the banks, who by switching short term capital from one country to another in order to exploit differences, which may exist for seasonal or other reasons, between the interest rates on the international capital markets, produce a leveling effect on these differences and ~~in so doing~~, contribute to the establish~~ment of~~ fair future rates. It is not possible to explain here the details of these somewhat complicated transactions, but it is obvious that they involve international capital transactions.

As the monetary plan, while asking for free exchange markets, excludes capital transactions from such freedom, I cannot see how a future exchange market could operate under it.

Another way to exonerate the foreign trade from the exchange risks would be a state guaranty. The idea of a governmental insurance of exchange risk seems to be under discussion.

Such insurance is in effect in Great Britain since 1940, organized under the Board of Trade, and in Canada. This insurance covers not only the exchange risks but commercial risks as well. A government insurance would mean, of course, further penetration of the government in the field of business and further interference with the activity of the foreign trade.

Still another way would be to turn over the future exchange business to the Central Banks as a monopoly.

The activity of the Central Banks in the future exchange markets is an extremely interesting chapter in the history of the evolution of the monetary technique. It would require a special study to tell the whole story, so I can give but a superficial picture of it at this time.

Reluctant for a long time to participate in any future exchange transaction, because they misunderstood the real nature of this branch of business and considered it as a mere speculation, the Central Banks appeared in the future markets in the early years of the 20th Century. As far as I know, it was the Austro-Hungarian Bank which as the first Central Bank used the manipulation of future exchange rates as an alternative to changing the bank rate. I think it was in 1905 that this Central Bank, in a situation in which the continuous outflow of capital peremptorily asked for a raise of the bank rate which on the other hand appeared unjustified owing to the low state of trade, used the manipulation of the future exchange rate as a way out of this dilemma.

The idea was to make the margin between the spot rate and the future rate of the Krone wide enough to induce foreign banks to buy spot Krone while selling simultaneously the same amount on future delivery and give the spot Krone so acquired to Austrian banks as a time deposit. The result was a full success: the Central Bank succeeded in changing the movement of funds ~~from out~~flow to influx.

The same technique, although in the opposite sense, was used in the late twenties by the Banque de France to avoid an inflationary increase of credit and money. At that time gold and foreign exchange was offered from abroad to the Banque de France in very great amounts against which the bank was forced to create franc deposits or issue money. To counteract this movement the Banque de France manipulated the future exchange rates of the franc in a way to make it attractive for foreign banks to sell spot francs and simultaneously buy future delivery, which resulted in the reflux to the Banque de France of the francs she had created.

Later, partly under the influence of Keynes's "Tract on Monetary Reform" in which he recommended the future exchange rate policy as an alternative to bank rate policy, all the central banks became active in the future exchange markets. These few examples show that the central banks, in manipulating the future exchange rates, were not concerned with the needs of the foreign trade, but only with matters of monetary policy. These transactions presuppose two conditions: First, the freedom of international capital movements, for their purpose is to regulate these capital movements, and second, the existence of future markets capable to absorb future transactions on a large scale. This brings us back to the question of freedom of international capital movements.

It would of course, be possible, to conceive a system in which future transactions would take place exclusively between Central Banks. This would mean free spot exchange markets and restricted future exchange markets. In this case the freedom of exchange markets would be a mere fiction because the foreign trader who would have to buy or sell future exchange would depend on the Central Bank. With other words the foreign trade would be controlled by the Government.

Thus we are once again faced by the same question we encounter everytime we try to foresee a solution of a post-war problem, i. e., free enterprise or government controlled economy? The answer to this basic question, which will shape our post-war economy, will be a political and not an economic one. Economic thinking does not make much sense outside definite political limits because any economic activity is determined by the political space in which ~~it takes~~ place.